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June 5, 2000

Honorable Vernon A. Williams
Secretary
Surface Transportation Board
Case Control Unit
1925 K Street, N.W.
Washington, D.C. 20423-0001

Re: STB Ex Parte No. 582 (Sub-No. 1); Major Rail Consolidation Procedures

Dear Mr. Williams:

Enclosed for filing in the above-captioned proceeding are the original and twenty-five (25) copies of Canadian Pacific Railway Company's Reply Comments (CPR-3). Also enclosed is a computer disk containing a copy of this submission in WordPerfect format.

Please date-stamp the two (2) extra copies of the enclosed filing and return them via our messenger.

Sincerely,

Terence M Hynes

Terence M. Hynes

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Office of the Secretary

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cc: All Parties of Record

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BEFORE THE
SURFACE TRANSPORTATION BOARD

STB EX PARTE NO. 582 (Sub-No. 1)

MAJOR RAIL CONSOLIDATION PROCEDURES

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REPLY COMMENTS OF CANADIAN PACIFIC RAILWAY COMPANY

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Counsel for Canadian Pacific Railway Company

DATED: June 5, 2000

BEFORE THE

SURFACE TRANSPORTATION BOARD

STB EX PARTE NO. 582 (Sub-No. 1)

MAJOR RAIL CONSOLIDATION PROCEDURES

REPLY COMMENTS OF CANADIAN PACIFIC RAILWAY COMPANY

Pursuant to the Board's March 31, 2000 Decision in the above-captioned proceeding (the *Rulemaking Order*), Canadian Pacific Railway Company and its wholly-owned subsidiaries, Soo Line Railroad Company ("Soo"), Delaware and Hudson Railway Company, Inc. ("DHRC") and St. Lawrence and Hudson Railway Company Limited ("St.L&H") (collectively, "CPR") submit these reply comments concerning possible modification of the STB's Railroad Consolidation Procedures (49 C.F.R. §§ 1180.0-1180-9).[1]

I. OVERVIEW

The opening comments filed by interested parties contain several constructive suggestions for revising the Board's merger regulations to take account of significant changes that have occurred in the railroad industry over the past two decades. However, a number of parties seek to convert this proceeding into a referendum on the STB's fundamental approach to economic regulation. The Board should decline the invitation of those parties to use this

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[1] CPR incorporates by reference the proposals set forth in its initial comments, and will not repeat those proposals here.

rulemaking – which is about the standards that should govern future rail mergers – to effect major changes in the overall scheme of rail regulation.[2]

The initial comments confirm that the most significant issues in future consolidation cases are likely to be about the impact of the transaction on the quality and reliability of rail service. A consensus has emerged that the STB should adopt regulations requiring future applicants to submit a detailed plan for implementing their transaction, and that the STB should monitor the implementation process. CPR generally endorses these ideas. In order to obtain approval for their merger, applicants should be required to demonstrate that they can implement the transaction without causing significant service disruptions. However, because the factors affecting success are likely to differ in each case, the Board's regulations should leave it to the applicants, in the first instance, to identify significant implementation issues and potential "choke points"; to present contingency plans to deal with potential service failures at critical locations; to identify appropriate criteria for measuring the success of merger implementation; and to offer (on a voluntary basis) service "guarantees" and/or remedies for shippers and connecting short-lines in the event that substantial service disruptions occur. The Board should weigh applicants' treatment of these service issues heavily in deciding whether to approve future merger transactions.

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[2] Nor is there any sound basis for instituting separate new rulemaking proceedings for the purpose of undertaking a broad reevaluation of the STB's policies with respect to rail competition. Those policies have been addressed at length in other recent STB proceedings. *See, e.g., Central Power & Light Co. v. Southern Pac. Transp. Co.*, STB Docket Nos. 41292, et. al., (served Dec. 31, 1995 and April 30, 1997) (*Bottleneck* decisions); *Review of Rail Access and Competition Issues*, STB Ex Parte No. 575 (served April 17, 1998 and March 2, 1999).

There also appears to be a consensus that the STB should repeal the "one-case-at-a-time" rule. However, there are divergent views as to how this change should be implemented. CPR urges the Board not to adopt an approach that would require it to decide whether to approve (or condition) a merger on the basis of speculation about hypothetical future transactions. Rather, the Board should use its oversight process to remedy cumulative or crossover effects of a responsive transaction that becomes a reality after the first transaction is approved. The STB should decide on a case-by-case basis whether to consolidate contemporaneous merger proposals.

The STB's current policy toward competition issues in rail merger proceedings, which seeks to preserve (but not enhance) the pre-merger competitive options of shippers, should be maintained. Commenting parties appear to agree that markets in which a proposed consolidation would reduce the number of rail competitors from three to two should continue to be analyzed on a case-by-case basis. Proposals that the STB impose new conditions to protect major rail gateways go further than is necessary to preserve pre-merger levels of competition. If the Board is nevertheless inclined to adopt such a condition, it should limit the applicability of the condition in future cross-border mergers to those north-south gateways that handle the largest volumes of cross-border freight.

The STB should not promulgate any regulation that would discourage (or prohibit) the acquisition of a U.S. railroad by a Canadian carrier. Such a policy would violate the principles articulated in the North American Free Trade Agreement ("NAFTA"). It would also ignore the reality that the rail system is part of an increasingly integrated North American economy. However, CPR endorses a regulation that would require applicants in a cross-border merger to submit "full system" operating plans and market impact analyses.

II. CPR'S RESPONSE TO INITIAL COMMENTS

A. Service Issues.

In its opening comments, CPR urged the Board to amend its regulations to require future merger applicants to submit a "Merger Implementation Plan." CPR proposed that the plan contain, at a minimum:

(1) A detailed description of the steps that applicants would take to integrate organizational structures, IT systems, customer service, train operations, yard and terminal operations, and other functions;

(2) A list of locations and/or functional areas in which the most significant changes would occur (and a contingency plan to deal with possible service failures); and

(3) Criteria by which the STB and the public can assess applicants' progress in delivering the promised benefits of the merger. CPR Comments at 9.

A number of parties have suggested additional elements for such a Merger Implementation Plan. These include:

(1) A requirement that applicants address the likely impact of the transaction on rail system capacity and infrastructure, and identify capital investments that would be required to assure the merged system's ability to meet the needs of its customers;[3]

(2) A requirement that applicants submit a plan concerning the level and deployment of rolling stock;[4] and

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[3] *See* CSX Comments at 16-17, App. E; NS Comments at 25-26; NYPA Comments at 14; Amtrak Comments at 6.

[4] *See* CSX Comments at 17, App. E.

(3) A requirement that applicants establish a post-merger "Service Council" similar to that created by NS and CSX in connection with the recent Conrail transaction.[5]

CPR agrees that the Merger Implementation Plan should incorporate these additional elements.

A number of parties proposed regulations that would require carriers to create and maintain data bases of uniform statistics by which applicants' "base line" (*i.e.*, pre-merger) and post-merger service performance might be measured.[6] CPR does not support this proposal, for several reasons. The critical implementation issues are likely to differ in each future merger case depending upon a variety of factors, including the number of points at which applicants' lines meet (and where "integration" is therefore required); the pre-merger compatibility of applicants' operations and systems; the volume of traffic applicants propose to reroute and/or divert from other carriers; the extent of changes in day-to-day operations required to implement the merger; and the capacity of applicants' pre-merger infrastructure. No single set of performance statistics can accurately measure the "success" of all future mergers. Moreover, given the network structure of the rail industry, the use of such statistics to evaluate the impact of a merger on particular shippers' freight would require that data be maintained not only by applicants, but also by non-applicant carriers with which they interchange traffic. A requirement that all carriers

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[5] *See* USDOT Comments at 7; CSX Comments at 12. All interested stakeholders – including shippers, governmental agencies, and connecting Class I and short-line carriers – should be represented on the post-merger "Service Council."

[6] *See, e.g.,* USDOT Comments at 6-7; UP Comments at 6-7; Association of Automobile Manufacturers ("AAM") Comments at 8-9; NITL Comments at 19.

routinely compile such a broad range of service statistics, which are not maintained by all carriers in the normal course of business today, would be both expensive and burdensome. CPR believes that, on balance, the burdens associated with maintaining such uniform data for the entire merger review/oversight period outweighs the data's potential value. Rather than adopting a "one size fits all" approach to monitoring the service aspects of future rail mergers, the Board should leave it to the applicants, in the first instance, to identify meaningful criteria by which the success of their merger implementation, and the delivery of the benefits promised in the application, can be evaluated.

While the Board should afford applicants substantial flexibility (in terms of specific evidentiary requirements) in addressing service issues, it should be more rigorous in its substantive evaluation of the impact of proposed mergers on the service provided by applicants (and by other carriers). In order to obtain approval for a major merger transaction, applicants should be required to demonstrate clearly that the transaction offers significant service improvements and/or other public benefits, and that those benefits are, in fact, likely to be achieved.[7] In deciding whether to approve the merger, the Board should also consider any service "guarantees" offered by applicants, as well as the availability (and likely effectiveness) of any remedies applicants offer to shippers and connecting short-lines for merger-related service failures. This approach will create a strong incentive for future applicants to present a "realistic" estimate of the benefits of their transaction. In particular, the inclusion of voluntary service

[7] The Board should consider not only those "conventional" benefits associated with past mergers (*e.g.*, new single-line service, reduced transit times and improved equipment utilization) but also any benefits derived from enhanced business processes, supply chain and logistics services or e-business applications offered by the merged system.

guarantees and remedies will deter applicants from overstating the level of services that they can deliver. *See also* USDOT Comments at 9-10.

Some commenters expressed a preference for new post-merger service remedies supervised by the STB, such as mandatory arbitration of carrier-shipper service disputes and an expedited procedure for filing "service complaints" with the STB.[8] USDA proposed that the STB "require railroads to indemnify shippers and other railroads for costs incurred due to merger related service interruptions."[9]

CPR believes that adoption of these remedies would be counterproductive. Mandatory arbitration or complaint procedures would create an environment that encouraged shippers (and short-lines) to litigate, rather than pursue informal solutions to, post-merger service problems.[10] A proliferation of formal complaint proceedings would divert railroad management attention and resources from the critical task of restoring an acceptable level of service. Indemnification or other mandatory financial penalties would drain the merged carrier of needed revenue, hindering its ability make the investments necessary to deliver quality service in the

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[8] *See, e.g.*, UP Comments at 8-10; AG Processing, Inc. Comments at 10; Canadian Pulp and Paper Comments at 6; American Shortline and Regional Railroad Association ("ASLRRA") Comments at 5-6; Farmrail System, Inc. Comments at 29; Dow Chemical Co. Comments at 14-15.

[9] U.S. Department of Agriculture ("USDA") Comments at 12-13; *see also* USDOT Comments at 3 (STB should "encourage indemnification of shippers, short line railroads, Amtrak and commuter railroads against significant implementation-related service problems").

[10] However, CPR believes that CSX's proposal to create an optional mediation procedure for smaller shippers (*see* CSX Comments at 18) could provide a cost-effective mechanism for addressing post-merger service issues affecting such entities.

longer term. Moreover, it would be difficult to develop standards for measuring service failures that are both meaningful for shippers and equitable to the railroads.[11]

The purchase and provision of rail service is a commercial transaction between the railroad and its customers. Rather than attempting to fashion new regulatory remedies for post-merger service failures, the Board's regulations should encourage merging carriers to develop service assurances and remedies that are commercially acceptable to both applicants and their shippers.[12] If serious post-merger service disruptions occur, the STB's *Ex Parte No. 628* regulations provide a mechanism under which shippers can obtain temporary access to alternative rail service. The Board's experience in dealing with the post-UP/SP service crisis shows that the approach embodied in *Ex Parte No. 628* is a workable solution.

Finally, certain parties suggested that applicants be required in all cases to implement their transaction in "phases" that would be supervised by the STB.[13] Under these proposals, applicants would be required to compartmentalize their transaction into discrete phases, and demonstrate to the Board's satisfaction that they had successfully completed one phase before moving on to the next. Such regulatory micromanagement of the implementation

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[11] Remedies based upon a specified decline in service measurements as compared to a pre-merger "base year" would appear to be of questionable value to shippers. Such "base year" data, by definition, reflect only the level of interline service provided by the applicants in a pre-merger period (usually two years prior to the year in which the merger is actually consummated). A remedy predicated upon a substantial and sustained deterioration of service below the level of interline service available several years prior to merger would provide little comfort to shippers anticipating significantly improved single-line service.

[12] This approach is supported by a number of commenters. *See, e.g.*, USDOT Comments at 9-10; NITL Comments at 19-20; Amtrak Comments at 12.

[13] *See, e.g.*, USDOT Comments at 10; CSX Comments at 13-16; Williams Energy Services Comments at 5-6.

process is neither necessary nor practicable. Depending upon the nature and scope of the transaction, "phased" implementation may, or may not, be the most appropriate manner in which to consummate a merger. Once the STB is satisfied that applicants' implementation plan is workable, it should not interject itself in the day-to-day process of managing merger implementation. Post-merger oversight (and, where necessary, action to afford shippers affected by service failures access to alternative carriers) will sufficiently protect the interests of the public.

B. Downstream Effects.

The initial comments reflect broad-based support for the STB's proposal to repeal the so-called "one-case-at-a-time" rule set forth at 49 C.F.R. § 1180.1(g).[14] However, there is less consensus with respect to the related question of how the Board should implement this change in policy.

Consideration of the "downstream" effects of potential responsive mergers poses a forensic and temporal dilemma for the Board. As the testimony presented to the Board at the March 2000 hearings in this proceeding indicated, a merger of two of the remaining major Class I railroads is likely to be followed by responsive merger proposals involving other Class I carriers. Yet, such responsive transactions may or may not actually come to pass while the first merger proposal is before the STB. In these circumstances, the Board must seek to fashion a procedure that enables it to protect the public from adverse cumulative and crossover impacts of

[14] *See, e.g.*, Association of Automobile Manufacturers Comments at 6; Association of American Port Authorities Comments at 4; Committee to Improve American Coal Transportation Comments at 14-16; NITL Comments at 5.

multiple consolidations, without unduly prolonging pending merger proceedings or rendering decisions on the basis of speculation about future events.

The STB can accomplish this objective in the following manner:

Where a responsive merger is announced during the course of a pending consolidation proceeding, the Board may choose, in its discretion, to consolidate the cases. The Board should not adopt any hard and fast rule that would **require** consolidation of all contemporaneous cases. Indeed, mandatory consolidation of all pending applications could itself harm the public by creating a situation in which carriers attempted to implement multiple mergers simultaneously (thereby compounding the likelihood of service disruptions). The decision whether to consolidate should be based upon the STB's assessment of several factors, including (1) how far the Board's consideration of the first transaction has progressed at the time the second transaction is proposed; (2) the apparent degree of "relatedness" of the two transactions; and (3) the likely impact on service quality of consummating the transactions simultaneously.

If the STB decides to consolidate multiple applications, it can address any cumulative and crossover effects of the proposed mergers in the consolidated proceeding. If the Board elects to process the applications independently, or if a responsive merger is not announced until after STB review of the first transaction has been completed, the Board can use the oversight process to consider cumulative and crossover impacts. Specifically, where a subsequent transaction generates adverse cumulative or crossover effects that can be remedied most effectively by imposing additional conditions on the first transaction, the STB can impose such conditions as part of its oversight of the first transaction.

This procedure would, of course, impose a degree of uncertainty on applicants in the first case regarding the totality of the conditions to which they might ultimately be subjected. In order to reduce such uncertainty, the Board should limit its exercise of this conditioning authority to situations in which a shipper presented credible evidence in the first proceeding that the pending merger, in conjunction with another as-yet-unannounced consolidation, would generate substantial adverse impacts that could most appropriately be remedied by imposing conditions on the first transaction. Upon such a showing, the Board could, in its decision approving the first transaction, place applicants on notice that it might impose the condition sought by the shipper in the event that the second merger came to pass. Thereafter, if the second transaction occurs within a reasonable time (not to exceed the oversight period), the shipper could petition the STB to impose its proposed condition. So limited, such a procedure would be preferable to one in which the STB determined the fate of the first transaction on the basis of guesswork regarding possible future consolidations.

C. Competition Issues.

As CPR's initial comments (at 11-13) demonstrate, it would not be in the public interest for the STB to adopt a fundamentally new policy under which it routinely sought to "enhance" (as opposed to preserve) intramodal competition in rail merger cases. Nevertheless, a number of shippers advocate expanded the use of the Board's conditioning power to increase the rail options available to shippers. None of these commenters offers any persuasive justification for adopting such a major policy change.

Some parties assert that increased concentration in the rail industry resulting from past mergers, in and of itself, justifies a change in policy.[15] This argument does not withstand scrutiny. While prior mergers have reduced the total number of Class I railroads in the industry, the Board (and the ICC) have taken great care in approving those transactions to preserve the competitive options of every shipper that would otherwise have been rendered captive as a result of the merger. There is no reason to expand competitive options in future mergers on the basis of the agency's alleged failure to protect the interests of shippers in prior mergers.

Several shippers argue that more direct rail competition is needed to control rates.[16] But the Board's rate reasonableness guidelines already constrain rail rates, and provide remedies for shippers whose rates are found to be unreasonable. A change in policy requiring open access, terminal switching or other forms of "enhanced" competition in future mergers would go far beyond what is necessary to ensure reasonable rates. Indeed, such fundamental restructuring of the industry would force rail rates below reasonable, sustainable levels, prevent railroads from recovering their total costs, and threaten further investment in the facilities and capacity improvements needed to serve shippers now and in the future.

Some parties urge the Board to establish a "rebuttable presumption" that all future rail mergers will harm competition (and therefore deny future applications unless the applicants

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[15] *See, e.g.*, Chemical Manufacturers Comments at 5-8; BASF Comments at 6-7; NITL Comments at 11-12.

[16] *See, e.g.*, BASF Comments at 46-49, 55-57; Chemical Manufacturers Comments at 7-9; NITL Comments at 11-12.

affirmatively demonstrate the absence of adverse competitive effects).[17] Such a presumption is not supported by the record in this proceeding, and in any event would be inconsistent with the Board's statutory mandate. *See* 49 U.S.C. § 11324. The Board should continue to apply the burden of proof on competitive issues in accordance with its traditional approach.

CN's comments identify one merger-related issue with respect to bottleneck rates: *i.e.*, the circumstance in which a proposed merger might extend a bottleneck and thereby extinguish the rights of certain shippers under the STB's *Bottleneck* decisions. CN Comments at 30-31. In order to address this issue, CN suggests that the Board consider "grandfathering" the rights of shippers that were entitled, pre-merger, to request a separate "bottleneck" rate quotation under the established "contract exception." *Id.* This protection would apply when, prior to a merger, a shipper had obtained a contract rate for the competitive portion of a movement, and therefore was entitled to request a separate "bottleneck" rate quotation for the remainder of the movement. CPR would not oppose such a "grandfather" condition, which would preserve the bottleneck rights enjoyed by shippers prior to the merger.

A number of parties proposed new merger conditions designed to maintain (or expand) open gateways for the interchange of traffic between carriers following a merger. CPR believes that these conditions generally are not necessary to alleviate anticompetitive effects caused by a merger. Indeed, such conditions could impair the merged carrier's ability to achieve desirable operating efficiencies and line density benefits. Therefore, CPR believes that these proposals should not be adopted in the Board's merger regulations.

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[17] *See, e.g.,* USDA Comments at 12; Western Canadian Shippers' Coalition/ Council of Forest Industries Comments at 3; Canadian Pulp & Paper Comments at 3-4; NYPA Comments at 4-5.

NS proposed a more limited gateway protection condition. Under NS' proposal, in the case of a transcontinental merger between U.S. carriers, the Board could impose a gateway protection condition that would apply to five designated Midwestern and Mississippi River gateway cities (Chicago, Kansas City, St. Louis, Memphis and New Orleans) that are "truly important, major, operationally feasible and efficient gateways." NS Comments at 37. This condition would apply to individual shippers that were exclusively served at origin or destination by one of the merging railroads, that before the merger could complete freight shipments only through an interchange served by another merging railroad and at least one independent railroad at these gateway cities, and that actually shipped a significant volume of freight via these interchanges prior to the merger. *Id.* at 37-38. The NS proposal would apply only to non-exempt traffic. *Id.* at 38, n.8. Eligible solely-served shippers could request that the merging carrier establish a common carrier or contract rate to/from the interchange gateway, in order to permit the shipper to continue to utilize interline service with an independent railroad. *Id.*

CPR believes that merging railroads have economic incentives to utilize more-efficient joint line routes rather than less-efficient single line routings, and that the condition proposed by NS goes beyond what is necessary to preserve competition in accordance with the Board's current standards. If the Board nevertheless decides to adopt the condition proposed by NS, and to apply it as well to north-south merger transactions, the Board would have to determine which gateway cities are "truly important, major, operationally feasible and efficient gateways" for cross-border traffic. The Chicago gateway dwarfs all other cross-border interchange gateways, accounting for more than twice as much of CPR's north-south traffic as its next largest interchange points (Detroit/Windsor and Minneapolis/St. Paul). Thus, Chicago would be the most significant gateway city in any merger involving CPR's north-south traffic flows, with Detroit/Windsor and Minneapolis/St. Paul a distant second and third.[18] If the Board were to adopt NS' proposal and apply it to a future cross-border merger involving CPR, Chicago, Detroit/Windsor and Minneapolis/St. Paul would be the gateways analogous to those identified by NS for east-west transcontinental mergers.

D. Measuring Public Interest Benefits.

Many commenting parties urged the STB to "raise the evidentiary bar" for future merger applicants by requiring them to prove more convincingly that their proposed transaction will produce significant public benefits.[19] As stated in its initial comments, CPR generally endorses an approach under which applicants' public benefits claims would be subjected to more exacting scrutiny. CPR Comments at 18.

Some parties urge the STB to go even further, by adopting a policy that affirmatively disfavors merger whenever the benefits identified by the applicants might be achieved by alternative means.[20] Based upon its experience with arrangements short of merger, CPR questions the wisdom of such a policy.

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[18] Like CPR, CN interchanges a substantial portion of its north-south traffic at Chicago. CN's secondary gateways might differ from CPR's.

[19] *See, e.g.*, NS Comments at 9-12; CSX Comments at 7; Amtrak Comments at 7; CN Comments at 12.

[20] *See, e.g.*, USDA Comments at 12 (urging STB to create a "rebuttable presumption against future major railroad mergers" unless applicants, *inter alia*, "prove the existence of merger-related benefits, and demonstrate that those benefits cannot be achieved by other means short of merger"); Alliance of Automobile Manufacturers Comments at 9 (STB should require applicants to "explain why such [service] improvements cannot be achieved through some means other than through the proposed transaction"); UP Comments at 18 ("mergers should not be credited with benefits that are practicably achievable through other means").

CPR has, in recent years, pursued a variety of strategic initiatives with unaffiliated rail carriers. *See* Exh. 1, V.S. Gantous at 1, 3-5. Based upon this experience, CPR believes that such cooperative ventures hold the potential for enabling railroads to achieve operating synergies, cost reductions, and improved service and commercial reach, even on a continent-wide basis. However, CPR's experience also indicates that achieving broad-based strategic agreements can be both difficult and time-consuming. Barriers to success may result from differences in the participating carriers' assessment of the relative costs, benefits and risks of the proposed venture; disagreement regarding how to allocate benefits; differences in the prospective partners' management styles and corporate cultures; differences in the capital available to (and competing capital requirements faced by) each party; and the impact of other initiatives that each party may be pursuing independently. Exh. 1, V.S. Gantous at 3.

As Mr. Gantous testifies, CPR continues to view strategic partnering as preferable to merger, and CPR is continuing to pursue a number of such initiatives with its U.S. Class I connections. However, while CPR is optimistic about the prospects for these ventures, there is no guarantee that it (or any other carrier) can achieve its commercial objectives exclusively by partnering with unaffiliated companies. Accordingly, CPR urges the STB not to adopt any policy that would have the effect of foreclosing the possibility of further consolidations. In particular, the Board should reject proposals that call for a regulatory "presumption" against mergers, or that would make the pursuit of (and failure to achieve) benefits via strategic alliances an absolute "prerequisite" to approval of a merger. If partnering with unaffiliated firms offers the most efficient (and lowest risk) means to greater efficiency and commercial viability, management's fiduciary duty to shareholders will lead the company in that direction.

Conversely, where management determines that a merger presents the best means of enhancing efficiency, the STB's policies should not foreclose (or erect unreasonable barriers to) that option.[21]

E. **Cross-Border Issues.**

Several parties proposed regulations relating specifically to cross-border control transactions. CPR endorses the most common suggestion of these parties – that applicants in cross-border transactions be required to submit "full system" operating plans and competitive impact analyses reflecting operations both within and outside of the United States.[22] The North American rail system is a highly interdependent network, and merger-related changes in one location can have far-reaching consequences even across international borders. CPR's difficulties in the wake of the UP-SP and CSX-NS-Conrail transactions have proven this to be true.[23] Therefore, applicants in any cross-border transaction should be required to present an operating plan, merger implementation plan, and competitive analysis that portray the impacts of the transaction across their entire system.

CPR also endorses UP's proposal that the STB use its conditioning power wherever necessary to remedy anticompetitive impacts of a proposed merger on cross-border

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[21] Consistent with its current policy, the Board should not credit merger applicants with public benefits arising out of "garden variety" commercial and operating arrangements that are commonly entered into by non-affiliated carriers.

[22] *See, e.g.*, UP Comments at 19; CSX Comments at 24; NS Comments at 62-63; NITL Comments at 22.

[23] *See* Testimony of Robert J. Ritchie, Ex Parte No. 582 (filed February 29, 2000) ("Ritchie Testimony") at 2-3 (describing service problems caused by recent mergers "across the CPR system," costing millions of dollars in fuel, crew and equipment, and causing aggrieved shippers to divert their freight to other modes of transportation).

shippers, even if the relief required involves trackage located in a foreign country. UP Comments at 21. The competitive consequences of a cross-border merger cannot be easily compartmentalized into those that affect the U.S. and those that affect the other country; in many cases, a reduction in competitive options at a point in one nation will affect shippers and receivers in both countries.[24] Where a proposed transaction would reduce competition for shippers engaged in cross-border trade (and therefore adversely affect the U.S. public interest), the STB should impose appropriate conditions to remedy such effects regardless of whether the condition would be implemented in the United States or in Canada. The STB can implement extraterritorial conditions by requiring applicants to enter into private contractual arrangements.

However, CPR vigorously objects to any proposed regulation that would impose unique burdens on "foreign" applicants, or would "disfavor" the acquisition of control of a U.S. railroad by a Canadian carrier. Any policy or regulation that discriminates against Canadian applicants in this manner would violate the trade policies of the United States and Canada, and would be contrary to the interests of shippers and consumers in both nations.

Chapter 11 of NAFTA expressly prohibits discrimination between U.S. and Canadian parties in connection with corporate control and investment transactions. Specifically, Article 1102 of NAFTA requires the United States to accord Canadian investors "treatment no less favorable than its accords, in like circumstances, to its own investors with respect to the establishment, ***acquisition***, expansion, management, conduct, operation, and sale or other disposition of investments." A plain reading of this provision prohibits the STB from

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[24] As a result of NAFTA, the north-south corridors serving Canada, the United States and Mexico are the fastest-growing rail markets on the continent.

"disfavoring" an application by a Canadian corporation to acquire control of a U.S. railroad solely on the basis of the acquiring entity's nationality. It also prevents the STB from imposing discriminatory conditions or restrictions on a Canadian carrier seeking control of a U.S. railroad. *See also* NAFTA Article 1106 (prohibiting the U.S. from imposing discriminatory performance requirements relating to Canadian acquisition or operation of investments in the U.S.); Article 1202 (requiring the U.S. to accord Canadian service providers, ***including transportation providers***, treatment no less favorable than it accords to its own service providers).[25]

Nor may the STB disfavor acquisition of a U.S. rail carrier by a Canadian railroad simply because the majority of the Canadian company's management and Board of Directors are of Canadian nationality. *See* CSX Comments at App. D-3. Article 1107 of NAFTA prohibits countries from requiring that senior management positions of corporations be held by individuals of any particular nationality. Article 1107 also expressly authorizes Canada (and the United States) to require that a majority of the board of directors of their domestic corporations be of a particular nationality "provided that the requirement does not materially impair the ability of the investor to exercise control over the investment." The Canada Business Corporations Act ("CBCA") currently requires that a majority of the board of directors of ***all*** Canadian corporations (not just railroads) be Canadian citizens. However, that statute places no limitation on who may be an investor in a Canadian corporation.[26] Accordingly, any policy that

[25] Canadian agencies are likewise required by NAFTA to afford U.S. investors an equal opportunity to acquire or operate Canadian businesses.

[26] In fact, the majority of the shares of CPR's parent, Canadian Pacific Limited, are owned by U.S. stockholders. The majority of CN's common stock is likewise held by U.S. citizens. CN Comments at 48.

discriminates against a control applicant managed or directed by Canadian citizens would likewise violate NAFTA. In any event, the directors of CPR (and CN) owe fiduciary duties to their stockholders that prohibit them from directing the affairs of their companies in a manner calculated to further the political interests of Canada (rather than the company's economic interests).

On the other hand, a wholly separate provision of Canadian law – applicable only to CN – prohibits any investor from owning more than 15 percent of CN's outstanding stock. While this provision does not on its face discriminate between U.S. and Canadian investors, it does effectively block an unwelcome takeover of CN by a U.S. railroad. This statutory provision cannot be modified or waived without Canadian government action. The implications of this provision for the U.S. public interest is an issue appropriately addressed in any future consolidation proceeding in which CN may be an applicant.

Other proposals to impose unique procedural or evidentiary burdens on "foreign" applicants should likewise be rejected. The proposal to require cross-border applicants to catalogue all regulatory and legal requirements of a foreign country that "pertain" to subjects treated in an STB application (*see* CSX Comments at 24-25) would impose an enormous burden on applicants. Canadian railroad operations are subject to regulation by the Canadian Transportation Agency under the Canada Transportation Act, which contains numerous provisions dealing, *inter alia*, with shipper rate and service protections, including competitive line rates, compulsory switching, and final offer arbitration. The Railway Safety Act confers broad power on the Minister of Transport to regulate such matters as the construction and maintenance of railways, the safety of persons and property transported by railways and the safety of other persons and other property. Other statutes, such as the Canada Labour Code and the Canadian Environmental Assessment Act, also have broad application to Canadian rail operations. In order to comply with the proposed regulation, applicants would have to present a massive "treatise" on Canadian laws affecting railroad companies and their operations. Such a filing would not significantly contribute to the STB's evaluation of the public interest merits of a cross-border transaction.

Likewise, there is no sound reason for the STB to require that cross-border applicants obtain all foreign approvals before bringing a transaction before the STB. CSX Comments at 25. Such a requirement would simply delay the public benefits of a cross-border merger. In any event, under current Canadian law, the only "conditions" that might be attached to a cross-border rail merger are conditions proposed by the Competition Bureau to ameliorate potential anticompetitive consequences of the transaction. It is highly unlikely that such competition–preserving conditions would be harmful to the U.S. public interest.

While CPR agrees that cross-border applications should include evidence concerning "full system" operations and market impacts, the Board should not extend its environmental regulations to cover all points in Canada. Unlike the competitive and service impacts of a merger, the environmental impacts of a merger (such as increased noise and grade crossing issues) are generally local in nature. Such environmental impacts occurring at local points in Canada do not significantly affect the U.S. public interest, and should be left to local regulation by Canadian authorities.

The concerns expressed by USDOT concerning railroad safety (which relate to the ability of FRA to enforce its regulations extraterritorially) provide no justification for disfavoring acquisition of a U.S. railroad by a Canadian carrier. There is no reason to suppose that Canadian ownership of U.S. rail lines would result in less safe operation of those lines than if they were owned by a U.S. company. CPR and CN both have conducted rail operations in the United States for more than a century. They have consistently complied with U.S. laws and safety regulations in conducting their U.S. operations, and will continue to do so. There is simply no evidence to suggest that the U.S.-based operations of CPR (or CN) are in any way less safe than those of U.S.-owned carriers. *See Canadian Pacific Limited, et al. – Purchase and Trackage Rights – Delaware & Hudson Railway Co.* STB Finance Docket No. 31700 (Sub-No. 13) (served June 16, 1998) at 7 (allegations concerning the safety of CPR's proposed dispatching of DHRC trains from Canada "[did] not furnish a legal basis" for reviewing an arbitrator's award. The STB noted, among other things, that CPR and its affiliates "have undertaken to comply with the highest standards under both Canadian and U.S. safety regulatory regimes.")[27]

[27] In connection with its recent proposal to transfer the dispatching of DHRC's lines to CPR's Montreal dispatching facility, CPR voluntarily agreed (with one exception necessitated by Canadian constitutional limitations) to comply with all FRA safety regulations, even though FRA's rules by their terms apply only to U.S.-based dispatching operations. *Id.* The sole exception was that CPR is not permitted to require random drug testing of its Canadian-based employees. The absence of random drug testing for Canadian dispatchers has not been shown to have any adverse effect on the safety of CPR's Canadian rail operations. In any event, FRA has indicated on several occasions that it is considering promulgating regulations that would require that all U.S. railroad lines to be dispatched from within the United States. Such a regulation would effectively moot the safety concerns expressed by USDOT.

Finally, issues raised by commenting parties concerning the possible impact of cross-border mergers on national security, favoritism of foreign producers, and the interests of U.S. ports (*see* DOT Comments at 36-39) provide no basis for the STB to impose special rules for cross-border transactions. The STB can address such concerns in the context of individual merger proceedings.

Respectfully submitted,

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DATED: June 5, 2000

EXHIBIT 1

VERIFIED STATEMENT
OF
WILLIAM GANTOUS

My name is William Gantous. I am Vice President – Corporate Planning and Finance for Canadian Pacific Railway Company ("CPR"). My business address is Canadian Pacific Railway, Suite 500, Gulf Canada Square, 401 – 9th Avenue, S.W., Calgary, Alberta T2P 4Z4. The purpose of this Verified Statement is to respond to the question posed in the STB's *Rulemaking Order* as to whether further consolidation is necessary to enable the rail industry to realize available synergies and operating efficiencies and to provide the services required to meet shipper demands now and in the future.

CPR is the only major Class I railroad that has not participated in a merger or consolidation transaction in the past five years. During this period, CPR has sought to improve the quality of service offered to its customers, and the value of its franchise to investors, by pursuing strategic partnerships with CPR's U.S. Class I connections. CPR adopted this strategy for a number of reasons:

First, CPR believes that the greatest challenge facing it (and other North American railroads) has been, and will continue to be, to provide dock to dock services that are "seamless" to the customer, regardless of how many carriers are required to complete the movement.

Second, as a result of NAFTA, the economies of Canada, the United States and Mexico are increasingly becoming aligned on the basis of production and inventory efficiencies, and less on the basis of national borders. As a result, cross-border flows of goods are growing (and are expected to continue to grow) at a far greater rate than domestic traffic flows within any one country. Indeed, in the post-NAFTA era, trade (and corresponding traffic flows) among the NAFTA nations has grown at a double-digit annual rate.

Third, shippers are increasingly demanding "value-added" services, on a multi-modal and global basis, that go beyond the traditional point-to-point movement of goods. These include supply chain and shipment management tools, on-line customer service interfaces, and a variety of facilities and services beyond the rail operation. In order to meet these shipper requirements, railroads must invest in improved information systems and business processes. Such investments can provide the greatest value, and be most cost-efficient, when they are developed and deployed on a multi-carrier or industry-wide basis (rather than on a proprietary basis by each individual railroad).

CPR's decision to meet these challenges through strategic partnerships, rather than via merger, is based in part on our perception of the "downside" risks associated with major merger transactions. A major Class I rail merger can have a massive impact on the participating companies' balance sheets (whether merger financing takes the form of increased debt or dilution of equity ownership). The "cost" of accomplishing a major merger can create significant financial pressure on management to realize synergies quickly – often too quickly. The consolidation of functions and rerouting of traffic flows may, for financial reasons, be effected on an accelerated basis, increasing the risk that critical operational details may be overlooked, or planning assumptions may be overly optimistic. When post-merger problems arise, the first party to suffer is the shipper. However, as service declines, the carrier's market position will deteriorate, as will its financial performance. Ultimately, the financial pressures that were at the root of the problem can be exacerbated.

Of course, no strategy is free of risk, and the alliance strategy currently being followed by CPR is no exception. Whereas mergers may pose a risk of disruptions due to an overly-aggressive implementation timetable, the pursuit of alliances can suffer from the converse risk of incompatible incentives and insufficient deployment of resources. Perhaps the single greatest obstacle to strategic alliances is the difficulty of overcoming the independent proprietary interests of unaffiliated parties. Each management's fiduciary responsibility to its own separate group of shareholders requires not only that an alliance arrangement creates synergy-related value, but also that such benefits be shared in an equitable way. This second test can create significant barriers to success. The prospective partners may assess the relative benefits, costs and risks of the proposed venture differently. They may be unable to agree on what constitutes a "fair" allocation of the anticipated benefits. They may have different capital requirements and priorities. Even differences in management style and culture can present obstacles to success. As a result, the negotiation of strategic partnership arrangements can be, at best, difficult and time-consuming. For these reasons, and based upon its own recent experience, CPR does not believe it to be a foregone conclusion that the remaining Class I carriers can achieve all of their goals (in terms of greater efficiency and modal competitiveness) exclusively through strategic partnerships among unaffiliated entities.

Nevertheless, CPR is optimistic that much can potentially be accomplished through strategic partnering among the major Class I carriers, and we are encouraged by the successes that we have achieved to date. Among those successes is a comprehensive arrangement with NS in the U.S. Northeast pursuant to which NS obtained access (via CPR's DHRC affiliate) to the GTI system and New England, and CPR obtained corresponding access to key population centers in the Northeast. As part of this agreement, CPR and NS shared the cost of rehabilitating a 70-mile segment of the CPR line to improve both carriers' service quality. Another such cooperative venture involved CPR's purchase of shipment management and yard management systems developed by NS. CPR estimates that it saved tens of millions of dollars of development costs by working with NS instead of developing its own proprietary systems. The arrangement similarly benefited NS by enabling it to recoup a portion of its original cost of developing these systems.

CPR believes that there exist other opportunities for such "win-win" partnering arrangements. Ironically, the U.S. Class I railroads' overriding concerns about their own merger transactions may have led them to ignore the potential benefits of strategic partnerships in recent years. However, it appears that the U.S. roads are becoming increasingly aware of the potential benefits of such cooperative ventures, as a result of the economic trends identified above and in response to their own customers' demands. CPR is working actively to take advantage of that awareness.

Perhaps the most promising (in terms of potential benefits) of the projects currently underway is a joint effort with UP to develop a broad range of coordinated, mutual benefits. That effort began in 1998, when the two companies set out to improve the corridor between Calgary, Alberta and Portland, Oregon (via the border interchange at Kingsgate, British Columbia). A joint team of operating and commercial management analyzed the service characteristics and capacity of the entire corridor, and identified necessary capital improvements and operating changes on both the CPR and UP segments of the route. Upon implementing the recommended changes, service has materially improved, and CPR and UP have been rewarded by retention of important business and substantial traffic growth.

Within the last year, CPR and UP have also negotiated and implemented a number of other strategic coordinations. We have entered into several local service coordination agreements, pursuant to which one carrier provides switching services for both itself and the other carrier. We have jointly developed and promoted new Canada/Mexico carload and intermodal services, featuring single-line billing and customer service. The companies have also agreed to a comprehensive routing protocol, which establishes the gateways to be used for each category of traffic, and eliminates much of the parochial thinking that often gets in the way of developing coordinated service between unaffiliated carriers. CPR and UP are continuing to pursue a more comprehensive alliance framework designed to (1) improve our interline services; (2) enhance the marketing of those services; and (3) reduce costs. This latest initiative encompasses all aspects of the two companies' interconnected business, and will explore (among other things) the potential for asset sharing and joint marketing authorities.

CPR is pursuing strategic partnering opportunities with other carriers as well. CPR, CSXT, NS and UP recently announced their coordinated equity investment in ArZoon, an internet-based company specializing in transportation and logistics. It is expected that this innovative enterprise will provide shippers the ability to obtain information to plan their transportation, purchase transportation services and monitor the execution of the transportation through a single information portal. We are actively engaged in discussions with CSX aimed at improving service in the Detroit-Chicago corridor.

In summary, CPR believes that strategic partnerships and alliance-type structures offer the potential for significant untapped value creation for our shareholders and our customers. We are buoyed by the level of cooperation exhibited in recent years by other Class I railroads, and we plan to continue to pursue this approach aggressively. However, CPR is aware that exclusive reliance on alliances for value creation is not without risk, and we will not rule out merger as a strategy for achieving both shareholder and customer value. CPR urges the STB to create a regulatory environment that will encourage railroads to pursue the potential of strategic partnering arrangements. This can be accomplished by streamlining (or eliminating altogether) the regulatory review process for alliance-type business arrangements between Class I carriers. At the same time, the board should not adopt any policy toward mergers generally (or, in particular, toward cross-border merger transactions) that would have the effect of foreclosing the possibility of further beneficial consolidations.

Verification

PROVINCE OF ALBERTA)

CITY OF CALGARY)

William Gantous, being duly sworn, deposes and says that he has read the foregoing verified statement, knows the contents thereof, and that the same are true as stated.

WS Gantous

William Gantous

Executed by me on this 2nd day of June, 2000.

Sworn before me at City of Calgary

Paul Guthrie

PAUL A. GUTHRIE
Barrister & Solicitor

CERTIFICATE OF SERVICE

I hereby certify that, on this 5th day of June, 2000, I served the foregoing Reply Comments of Canadian Pacific Railway Company by messenger or by postage prepaid, first class mail upon all known parties of record shown on the service list by the board on April 28, 2000, as supplemented.

Terence M. Hynes